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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN, *Petitioners*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MAX BARNETT and ESTHER BARNETT, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MICHAEL J. IPPOLITO and AGNES IPPOLITO, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioners pray that writs of certiorari issue to review judgments of the United States Court of Appeals for the Second Circuit, entered in the above-entitled cases, sustaining the disallowance of interest deductions on valid indebtedness. Judgment was entered in each case on July 22, 1966.

Opinions Below

The findings of fact and opinion of the Tax Court in *Kapel Goldstein, et al.* v. *Commissioner* are officially reported as 44 T. C. 284.

The findings of fact and opinion of the Tax Court in *Max Barnett, et al.* v. *Commissioner* are officially reported as 44 T. C. 261.

The findings of fact and opinion of the Tax Court in *Michael J. Ippolito, et al.* v. *Commissioner* are reported as T. C. Memo., No. 1965-167.

The opinions of the Court of Appeals have not been officially reported as yet.

Statute Involved

INTERNAL REVENUE CODE OF 1954

Sec. 163 (a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

The Facts

(Kapel Goldstein, et al. v. Commissioner*)

Tillie Goldstein (hereinafter petitioner) and her husband, Kapel Goldstein filed a joint Federal income tax re-

* The facts in the other two cases are separately stated, beginning at page 22.

turn for the year 1958 employing the cash receipts and disbursements method of accounting. In the fall of 1958 Petitioner won the Irish Sweepstakes and collected $140,218.75. In all of the transactions hereinafter described, Petitioner was represented by her son Bernard Goldstein (hereinafter Bernard), a certified public accountant, who acted as her agent.

1.

On or about December 31, 1958 Bernard purchased for petitioner $500,000 face amount U. S. Treasury Notes, 1½% due October 1, 1962 through Garvin, Bantel & Co. (hereinafter Garvin, Bantel) members of the New York and American Stock Exchanges engaged in the securities business. Garvin, Bantel were also money brokers. The purchase price was $464,687.50 plus accrued interest of $1,875.00 for a total of $466,562.50. On or about December 31, 1958 Petitioner borrowed $465,000.00 from the First National Bank of Jersey City (hereinafter Jersey City Bank) to complete the payment for the Treasury Notes. The loan was evidenced by a promissory note, signed by petitioner, due October 15, 1961 with interest at 4% per annum and secured by a pledge of the Treasury Notes. The note was with full recourse and further provided that either party could accelerate the maturity of the note after thirty days. On or about December 30, 1958, petitioner paid, by certified check, to Jersey City Bank, the sum of $52,596.61 as interest in advance to the maturity of the note.

During May, 1959, petitioner was advised that the Jersey City Bank would exercise its call privilege. On or about June 9, 1959, petitioner refinanced the Jersey City Bank loan with Gruntal & Co., securities brokers (hereinafter Gruntal) on a month to month basis. Jersey City Bank

delivered the Treasury Notes to Gruntal against payment of the note together with its check to petitioner for $42,944.61 representing a rebate of a portion of the interest previously paid by petitioner.

On or about December 1, 1959, petitioner sold the Treasury Notes for a price of $458,894.37 plus accrued interest of $1,270.49 for a total of $460,254.86 which amount was credited to Petitioner's account with Gruntal. On the same day, petitioner purchased $500,000.00 face amount U. S. Treasury Bonds, 2½% due November 15, 1961 (hereinafter Treasury Bonds) for a price of $477,109.38 plus accrued interest of $583.79 for a total of $477,693.17, which amount was charged to petitioner's account with Gruntal.

On or about February 4, 1960, petitioner sold $250,000.00 face value of the Treasury Bonds for a total of $242,657.97 including accrued interest. On or about June 13, 1960, petitioner sold the remaining $250,000.00 Treasury Bonds for a total of $247,384.51 including accrued interest. The proceeds from both sales were credited to petitioner's account with Gruntal.

2.

On or about December 31, 1958, petitioner purchased from Royal State Bank of New York (hereinafter Royal State) $500,000.00 face amount U. S. Treasury Notes, 1½% due October 1, 1961. The purchase price was $475,937.50 plus accrued interest of $1,875.00 for a total of $477,812.50. Petitioner paid the purchase price by borrowing $480,000.00 from Royal State and executed a full recourse note due June 30, 1960, secured by a pledge of the Treasury Notes, with interest at 4% per annum. On or about December 30, 1958, petitioner paid, by certified check to Royal State the sum of $28,800.00 as interest in advance to the maturity of the note.

On or about June 9, 1960, petitioner sold the Treasury Notes for a price of $487,187.50 plus accrued interest in the amount of $1,434.43 for a total of $488,621.93. The proceeds were used to pay off the $480,000.00 loan from Royal State and the balance, together with a rebate of a portion of the interest, previously prepaid by petitioner, in the amount of $1,200.00, was remitted to petitioner.

At no time did any of the lenders or brokers involved in the foregoing transactions sell short the subject or equivalent securities as a means of financing the loan to petitioner; petitioner retained ownership of the Notes and Bonds for periods ranging from three months to 18 months; all transactions were affected at the prevailing market prices for the days involved; all transactions were executed upon the instructions of Bernard acting as agent for petitioner; and there were no prior arrangements or commitments of any kind by any party with respect to the ownership or disposition of the securities.

Petitioner, in the joint income tax return for 1958, deducted the interest paid to Jersey City Bank and Royal State in the amounts of $52,596.61 and $28,800.00 respectively, or a total of $81,396.61. All rebates of interest and gains on the sales of the securities were reported in the income tax returns of petitioner for the years in which realized.

Questions Presented

Is it proper to deny the deduction, under Section 163 of the Internal Revenue Code of 1954, of interest prepaid on loans obtained from banks to pay part of the purchase price of United States Treasury securities where the subject transactions are regular in every respect, but the tax-

payer's sole motive in entering into the transaction is presumed to be the avoidance of income tax.

Preliminary

These cases involve the deductibility of interest under Section 163 of the Internal Revenue Code of 1954 (hereinafter 1954 Code). In each of the cases, the petitioner placed orders with a broker to purchase U. S. Treasury Certificates. The orders were duly executed and in each case moneys were borrowed from a bank to pay part of the purchase price and interest was prepaid on the borrowing. The petitioners duly executed and delivered promissory notes for the amount of the loans to the respective lenders with full recourse. The interest was paid in cash. The hypothecated securities were retained by the lending banks until the taxpayers sold their securities and paid off their loans with the proceeds.

The three cases joined in this petition were heard together by the Court of Appeals. The principal decision was issued by the Court in the case of *Kapel Goldstein, et al.*, with subsidiary decisions in the other two cases, following *Goldstein,* and making certain further observations. The essential question in the three cases is the same, although the Court held the transactions in *Barnett* and in *Ippolito* were "sham", but not in *Goldstein.* In compliance with Rule 23, the three cases are consolidated in this one petition (separate appendices are provided), which is framed in terms of petitioner Goldstein alone in the interest of clarity. A brief addendum deals with the issue of "sham" in the other cases.

Petitioner's purchase of Treasury securities is no different in form or substance from thousands of such purchases made by taxpayers every day.

There was *no short sale* by anyone.[1] Petitioner's securities were pledged for purchase-money loans with two banks, as is the common every-day custom. The transactions were regular—ordinary.

In fact, the Second Circuit so found, rejecting the Tax Court's view that the transactions were "sham". Instead, it endorsed Judge Fay's dissenting view that the loan arrangements were "' . . . regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of government securities.' 44 T. C., at 301 . . . " (App., Goldstein, 70a).

The Second Circuit, nevertheless, disallowed the interest paid by petitioner on this wholly regular indebtedness as a deduction under Section 163. Postulating the existence of a "close question," the Court looked to the Congressional purpose underlying Section 163 and concluded that petitioner's interest payments, although entirely real—in no respect sham—were not deductible because her borrowings

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[1] In certain earlier cases, United States government obligations purchased and then pledged by taxpayers were sold short by the pledgees and the proceeds of such sales were advanced to the pledgors as "loans" with which to pay the obligations. Deduction of the interest paid on such "loans" by the pledgors has been denied in such cases. Cf. *Goodstein* v. *Com.*, C. A. 1, 1959, 267 F. 2d 127; *Lynch* v. *Com.*, 1960, C. A. 2, 273 F. 2d 86, aff'g 31 T. C. 990; *MacRae* v. *Com.*, 1961, C. A. 9, 294 F. 2d 56, aff'g 34 T. C. 20, cert. den., etc. As stated by the Tax Court in *MacRae, supra* (at p. 27), the short sale by the dealer neutralizes the original purchase by the taxpayer-pledgor. This is not such a case; the securities purchased by the petitioner in this case were pledged with a bank which retained the securities as collateral in the usual way throughout the duration of the loan.

were not "purposive." The deduction is allowable, the Court said, if the taxpayer's desire to receive an interest deduction is "only one of mixed motives" for the borrowing—if there is "some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction" (App. 78a).

This is a new and far-reaching thesis, superimposed on the interest deduction after a half century of its application and interpretation. It is, we submit, ill-founded, resting on a series of invalid assumptions. It ignores time-tested precepts laid down by this Court. It is in hard conflict with the principle applied in parallel decisions by other Courts of Appeal. It advances an irrational and impractical test of mischievous potential for many investors and for the security markets, particularly the market for United States obligations. All of this is readily apparent.

The first false premise of the decision below is that a "close question" exists. As the Court conceded, petitioner's transactions were "regular" and "indistinguishable from any other legitimate loan transaction." Interest is deductible on "other" legitimate transactions and the statute provides no visible basis for differentiating one legitimate loan transaction from another.

The statutory language is clear and uncomplicated. But the court ignored its plain directive and obviously gave thought to the moral aspect—whether the statute *should* allow the deduction in view of petitioner's presumed motive. On that basis, the question may be close, but it is wholly irrelevant.[2] The taxpayer is entitled to the benefit of the statute as it is written.

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[2] Cf. *Maxwell Hardware Co.* v. *Com.*, 1965, C. A. 9, 343 F. 2d 713, 720, viz.: "Taxation is peculiarly a matter of statutory law,

No possible ambiguity appears in Section 163 to require an external search for its meaning. Long-standing precepts of this Court bar such a search where the meaning is plain.[3] Close analysis of the lower Court's unorthodox interpretation confirms the wisdom of those precepts. See *infra*.

A second false premise appears in the Court's statement of the Congressional purpose. "The underlying notion", as the Court puts it, of Section 163 is that, "if an individual or corporation desires to engage in purposive activity, there is no reason why a taxpayer who borrows for that purpose should fare worse . . . than one who finances the venture

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and in applying that law to the determination and computation of income and deductions, the Courts do not make moral judgments. . . . It is not a matter of conscience but of statute and the determination of Congressional intent."

[3] In *Old Colony Railroad Company* v. *Com.*, 1932, 284 U. S. 552, 52 S. Ct. 211, this Court held that in construing the phrase "interest . . . on its indebtedness" as used in section 234, 1921 Act (cognate to present section 163), "(T)he legislature must be presumed to use words in their known and ordinary signification, *Levy's Lessee* v. *M'Cartee*, 6 Pet. 102, 110 . . ." and this ". . . is always to be preferred to any curious, narrow, hidden sense that nothing but the exigencies of a hard case and the ingenuity and study of an acute and powerful intellect would discover, . . . *DeGanay* v. *Lederer*, 250 U. S. 376, 381." Similarly: *Deputy, et al.* v. *du Pont*, 1939, 308 U. S. 488, 60 S. Ct. 363. Cf. *Com.* v. *Clay B. Brown*, 1965, 380 U. S. 563, 85 S. Ct. 1162, where this Court recently said of the term "sale" as used in Section 117, 1939 I. R. C. (relating to capital gains and losses): "A 'sale', however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code. Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning. . . . (cit.)."

It may be supposed that plain language in a statute serves as a beacon to the taxpayer which becomes a trap for the unwary if a hidden or twisted meaning is applied.

with capital that would otherwise have been yielding income" (App. 78a).

The flaw in the Court's statement is the proviso, i.e., that the interest deduction was intended to apply only if a taxpayer desires to engage in "purposive" activity. The Court offers no reference to any specific Committee Report or other authority for its statement. Others have stated the Congressional purpose differently.[4] The Court's statement begs the question, assuming what needs to be proved. What we are given, obviously, is the Court's conception of the "Congressional intent", tailored to fit its own moral view of what the statute *should* provide, rather than what Congress did, in fact, provide.

The thesis of the lower Court does not fit the statute as written, but rather, contradicts its plain and rational meaning. The Court has introduced "motive" as an element in Section 163, although the provision makes no mention of it and this Court has long taught that motive is irrelevant in applying a tax statute.[5] The test that the Court has interposed is essentially, "motive to make a profit." But "indebtedness" in Section 163 has always and necessarily encompassed personal borrowings. Can the single, indivisible word be rationally interpreted to require a

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[4] In *L. Lee Stanton*, 34 T. C. 1, at page 7, Judge Murdock wrote for the majority that, apart from the requirement that the transaction be real, "Congress has indicated that this deduction is not dependent in any other way upon the purpose or motive of the borrower or the use made of the borrowed money." Cf. Judge Fay's dissent in *Goldstein* to the effect that there is no legislative history indicating an intent that contradicts the plain meaning of Section 163 (App. 58a).

[5] Cf. *Gregory* v. *Helvering*, 1935, 293 U. S. 465, 55. S. Ct. 266. Where Congress has desired to impose a test relating to "motive", it has done so explicitly, as in the case of Section 269, relating to "acquisitions to evade or avoid income tax."

profit motive in some transactions, but not in others? To attribute such a schizophrenic intention to Congress surely demeans the legal process itself;[6] no less, an interpretation which validates personal borrowings to gamble, for example, or for a variety of other antisocial purposes—without semblance of restriction on motive—but would differentiate one legitimate loan to pay for United States securities from another on the basis of presumed motive.

Indeed, the conclusion of the Court below, that Congress did not intend to allow the interest deduction in a transaction motivated solely by tax avoidance is flatly contradicted by the legislative history of the statute.[7]

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[6] The Commissioner's own regulations provide categorically: "§1.163-1. Interest deduction in general. (a) Except as otherwise provided in sections 264 to 267, inclusive, interest paid or accrued within the taxble year on indebtedness shall be allowed as a deduction in computing income . . ." The present case does not fall within any of the express exceptions stated in Sections 264-267 of the Code. When, for example, Congress desired to limit the deduction for losses in respect to certain business, profit and personal classifications, it did so by explicit enumeration. Section 165, 1954 I. R. C.

[7] The legislative history of Section 23(b) (identical antecedent of present Section 163) is traced at length in the case of *L. Lee Stanton, supra*, at pp. 7-8. This shows that proposed amendments to the provision, designed to bar the interest deduction on "indebtedness incurred or continued for the purpose of evading the payment of taxes", were repeatedly stricken from proposed Revenue bills.

Whenever Congress desired to limit the allowance of a deduction for interest, it has repeatedly done so by specific legislation. It has done this over the years by denying a deduction for interest on indebtedness to purchase or carry tax exempt securities (Section 265(2)); by denying a deduction for interest on indebtedness to purchase single premium annuity contracts (subsequently further modified) (Section 264(a)(2)); by denying a deduction for interest on indebtedness incurred to purchase certain types of life insurance (Section 264(a)(2)), etc. It has denied a deduction for losses sustained in "wash sales" (Section 1091), etc. Instances of this sort are, of course, too common and numerous to be detailed in full here.

We submit that the principle of this case is clearly irrational; it may be expected to beget uncertainty and confusion in the administration of Section 163. It is, moreover, impractical and latently mischievous.

Given the condition that a taxpayer knows at the outset that any economic loss he may sustain on his investment will be offset by the deduction for interest paid, we submit that no one—no mortal, at least—may be reasonably sure what his true motive was in making the purchase, not even, perhaps, the individual himself. The certainty of redemption from loss is too strong an incentive for the ordinary human being to ignore. How is one to probe the innermost thoughts of each investor?

The case of *L. Lee Stanton, supra,* is significant on this. Stanton, a floor broker for an odd-lot house on the New York Stock Exchange, bought $5,000,000 face amount of U. S. Treasury 1½% Notes maturing in two years, for $4,921,968.75, plus accrued interest. He borrowed $5,000,000 from four banks at 3% interest, nearly twice his yield of 1.55%, to pay for the Notes. Stanton realized a pre-tax (economic) loss on the resale of the Notes, but a profit after deduction of the interest he paid on his loan.

The Tax Court held Stanton could properly deduct the interest paid on his loan.[8] Four judges dissented. While finding that Stanton had expected to realize a profit before taxes (at p. 4) and concluding that "it was a transaction entered into for profit" (at p. 8), the majority went to great lengths in tracing the legislative history of the interest deduction provision and analyzing its language, concluding:

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[8] See also *Hood* v. *Com'r* (1961), 20 T. C. M. 1140 and *Sadie S. Friedman* v. *Com.* (1960), 34 T. C. 456, remanded on another ground, C. A. 1, 1961, 294 F. 2d 876.

> "Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit or that it cannot be borrowed for nonbusiness purposes or used in an action entered into for profit or that it cannot be borrowed for personal or nonbusiness purposes or used in a transaction involving tax benefits, cf. *Commissioner* v. *Park*, 113 F. 2d 352, and the Tax Court has no authority to read or write such requirements into the law."

In light of its finding that Stanton did in fact expect a pre-tax profit, the majority's painstaking analysis of the history and language of the statute and its positive conclusion that the deduction is not dependent on profit motive evidently reflect two facts: (1) The four dissenting Judges strongly questioned Stanton's true motive; one went so far as to suggest that Stanton had been motivated by Livingstone—the entrepeneur of the short-sale transactions at issue in *Goodstein* v. *Com., supra*, and a host of other cases (Pierce, J., at p. 17). (2) It strongly suggests that the majority, itself, was not entirely sure of Stanton's motive. That inference is strengthened by this further statement in the majority opinion:

> "The Internal Revenue Code imposed heavy taxes upon Lee and he sought a legal way within the provisions of the Code to make a profit for himself after taxes, the only kind of profit which can do any taxpayer any good" (at p. 8).

The impracticality of asking revenue agents to make a fair determination as to the true motive of a particular taxpayer in this situation is evident. Or is the Revenue

Service now to instruct its field agents to give wealthy brokers the benefit of the doubt, and to disallow the deduction automatically to all sweepstake winners? What about the ordinary investor? An odd lot floor broker like Mr. Stanton has no greater expertise in the Government securities area by reason of his calling than many an amateur or semi-professional investor with a bit of native acumen about money and a habit of reading the financial news.[9] There is the problem.

The ordinary investor who may feel there is a profit potential in a margin purchase of Treasury securities might well hesitate if he's prudent or well-advised, and ask himself: "Will they believe my motive was to make a profit? I can't risk losing the deduction for the interest I'll have to pay, since then I'll have a certain loss."

Multiply this by the hundreds, or thousands, and the rule applied here must, in due course, alter the breadth and liquidity of the market in government obligations.

It is not humanly practical to determine with any certainty what motivated a taxpayer in these transactions. The principle laid down by the Second Circuit defies reason, also, in supposing that tax motive may be the *sole* reason in any case. " . . . the interest deduction should be permitted," the Court wrote, "whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds" (App. 78a). Petitioner was denied her deduction on that premise. The fallacy of this is that, whatever the

[9] The function of an odd lot floor broker on the New York Stock Exchange is to buy and sell round lots of securities (multiples of 100 shares) as odd lot orders (under 100 shares) are received from member firms, in order to keep the securities position of his firm in the desired balance.

odds, the possibility of profit exists when obligations of the United States are bought, whatever the price. The securities have a free market that fluctuates with various influences, particularly the condition of the money market. It is unrealistic to suppose that one who buys these obligations with partly borrowed money simple exercises all hope and expectation of realizing the potential economic profit, apart from the interest deduction, from his mind and heart. If the possibility exists, the hope also exists. The hypothesis of the lower Court that there may be a pure tax motive in a case like this is fanciful.

There is thus presented here the question whether interest paid on a loan to pay for United States Treasury securities may be denied as a deduction where the taxpayer's motive in entering into the transaction is presumed to be solely to avoid income tax—although the transaction is in no way sham.

Petitioner submits that since no proper basis appears to differentiate between Section 163 and various other provisions of the Internal Revenue Code, the question really presented is whether any transaction may be disregarded for tax purposes where the sole motive may be presumed to be tax avoidance.

By granting certiorari in this case, this Court can clear away a great burden of uncertainty and confusion. The broad character of the principle announced and the fundamental ground of legislative purpose on which the decision purports to rest make it a potentially important precedent, not only for the interest deduction but for other areas as well. The uncertainty and confusion are likely to be aggra-

vated by the conflict that exists between the Second Circuit and two others as to the validity of the principle applied and, also, by the evident misapplication by the Second Circuit of this Court's decision in *Knetsch* v. *U. S.*, 1960, 364 U. S. 361, 81 S. Ct. 132. See *infra*.

Reasons for Granting the Writ

1. A conflict in controlling principle exists between this case and *Fabreeka Products Co., et al.* v. *Com.*, 1961, C. A. 1, 294 F. 2d 876. The facts of the two cases are not the same, but the conflict is, nevertheless, direct and outright, demonstrating the broad reach of the principle at issue.

In *Fabreeka Products*, the First Circuit held that a purchaser of securities is entitled to the tax benefits of Section 171 of the 1954 Code *even though it was properly found that the purchase was made solely to obtain the tax benefit.*[10] Section 171, as then constituted, gave a taxpayer who purchased callable bonds at a premium the right to amortize the premium to the earliest call date, whether the bonds were called or not.[11] The Fabreeka Company had purchased public utility bonds callable in 30 days at a premium, held the bonds for 30 days (they were not called), and then distributed them as a dividend to its shareholders. The recipients promptly sold the bonds for about the same premium as the Company had paid. The Commissioner opposed

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[10] Similarly: *Maysteel Products, Inc.* v. *Com.*, 1961, C. A. 7, 287 F. 2d 429, rev'g and rem'g 33 T. C. 1021.

[11] This was intended to compensate for that part of the coupon interest received which exceeded the actual yield of the bonds to the particular purchaser, reflecting the premium paid, which was taxed as ordinary income. H. Rept. No. 2333, 77th Cong., 2d Sess., at pp. 92-95; *Hanover Bank* v. *Com.*, 369 U. S. 672 (1962).

Fabreeka's deduction of the premium it had paid because the sole motive of the transaction was tax reduction.

While recognizing that the Commissioner's charge was "amply supported," the Court of Appeals nevertheless held the taxpayer's motive did not make its transaction sham. It said:

> "Unless Congress makes it abundantly clear, we do not think that tax consequences should be dependent upon the discovery of a purpose or state of mind, whether it be elaborate or simple. The limitation which the government asks us to read into the statute even if appealing in a particular instance, might readily, as we said in another connection in *Eaton* v. *White*, 1934, 70 F. 2d 449 at 452, 'create difficulties and uncertainties more objectionable in their results than any seeming inequities which would be eliminated or prevented'."

Section 163 and Section 171 are similar in design and purpose. Section 163 was designed to put borrowers on a par with those who use capital. Section 171 was enacted to put purchasers of non-exempt bonds on a par with purchasers of tax-exempt bonds, in respect of a premium paid; it permitted amortization of the premium in lieu of a capital loss. Thus, each provision was designed to cure an inequity.[12] Neither refers expressly to motive. Both cases were decided on the premise that the taxpayers purchased the bonds with no motive save tax avoidance. In *Fabreeka*, the First Circuit held the taxpayer's motive was immaterial; here, the Second Circuit made it the crux of the decision. The conflict is clear.

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[12] Amortized bond premium is a cost of carrying the bond similar to interest.

2. The conflict between the two circuits gains significance from another fact: Each Court offers as authority for its own contrary position the decision of this Court in *Knetsch, supra.* It thus appears in plain view that the lower courts are confused, and in disagreement, as to the true meaning of *Knetsch.* This case, we submit, reflects a plain misapplication of the doctrine of *Knetsch.*

In *Knetsch,* the taxpayer reborrowed all of his own payments on an ostensible $8,000,000 annuity, leaving a net cash value of about $1,000, and this Court concluded that, "Knetsch's transactions with the insurance company did not affect his beneficial interest except to reduce his tax." There was no substance to the claimed indebtedness. In this case, the petitioner borrowed money to pay for securities which she purchased and which she continued to own at all relevant times—an arrangement which the lower court itself deemed "indistinguishable from any other legitimate loan transaction." The lower Court has obviously misconceived the true meaning of *Knetsch* in this case.[13]

In *Knetsch,* also, this Court "put aside a finding . . . that Knetsch's only motive in purchasing [the annuity] was to attempt to secure an interest deduction." The Second Cir-

[13] In *Knetsch,* this Court adopted the test suggested by Judge Hand dissenting in *Gilbert, et al.* v. *Com.,* C. A. 2, 1957, 248 F. 2d 399, 410-411, i.e., that the transaction must appreciably affect the taxpayer's beneficial interest. It is clear that this Court held in *Knetsch* that the interest was not deductible because the transaction was essentially unreal and not because the taxpayer had sought to avoid the tax. Similarly, in his *Gilbert* dissent, Judge Hand stated that the taxpayer, "will also be relieved, if he supposes that the transaction will, or may cause him a loss, although in that event it is true that his only motive will be to avoid the tax." The decision of the Court below in this case is clearly contrary to the foregoing in principle.

cuit evidently interpreted this as leaving open for consideration the question of taxpayer's motive. The First Circuit clearly understood that *Knetsch* precludes consideration of the taxpayer's motive. The confrontation of the Circuits over the meaning of *Knetsch* is direct and bold. The significance of the issue as presented in this case, for the orderly administration of the revenue, for investors and for the government bond market, make it an appropriate medium for the clarification of *Knetsch*, as well as for the resolution of the conflict between the First and Second Circuits.

3. The full ramifications of the decision in this case are hard to measure, but they are necessarily broad. The identity of basic issue with *Fabreeka Products*, arising under a different Code provision, fairly attests this. Nothing in the terms or history of Section 163 makes the principle peculiar to the interest deduction. It is common, for example, for taxpayers to sell securities at a profit in order to offset prior capital losses which are non-beneficial, and then to repurchase the same securities after a short interval in order to continue the investment. Such a sale and purchase are clearly effected solely for tax purposes, yet have always been recognized as valid and effective.[14]

What if a corporation issues debentures as a dividend to its stockholder solely to obtain a deduction for interest thereafter paid on such debentures, in lieu of non-deductible dividends? That precise question was presented in

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[14] In respect to sales at a *loss*, Congress enacted the so-called "wash-sale" rule, barring deduction of the loss if substantially identical securities are acquired by the taxpayer within a period beginning 30 days before the date of sale and ending 30 days after such date. Section 1091, 1954 I. R. C.

Kraft Foods Co. v. *Com.*, 1956, 232 F. 2d 118. The Second Circuit there held that the debentures might not be disregarded for tax purposes, rejecting the Commissioner's complaint that the sole purpose of the transaction was to minimize taxes. The divergence of principle between that case and this one must certainly confound the application of Section 163 for taxpayer and Revenue Service alike. Which rule shall apply in future cases of variant facts but identical tax-saving issue?

The circumstances in which transactions may be carried out solely for tax purposes, or which are practical solely by reason of the tax consequences, appear highly diverse.[15] The importance of the issue herein cannot be exaggerated, generally, as well as for the interest deduction specifically.[16]

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[15] Cf. *Com.* v. *Clay B. Brown, supra,* in which this Court held that the sale of a business to a tax-exempt organization, to be paid for out of the income of the business within 10 years, provided a capital gain to the seller. As Mr. Justice Harlan, wrote in his concurring opinion, "were it not for the tax laws, the respondent's transaction with the Institute would make no sense, except as one arising from a charitable impulse."

[16] The importance of the issue is attested by published reports of the Federal Reserve Board, which show that in the month of April, 1966, alone, New York Stock Exchange member firms extended credit to customers, on securities pledged as collateral, in the total amount of $5,671,000,000. In the same month banks extended credit to customers (other than brokers and dealers) in the total of $2,283,000,000. Of these amounts, $26,000,000 and $105,000,000 in loans were made on the collateral of U. S. Government securities. During this same period, brokers and dealers borrowed $108,000,000 on the security of U. S. Government bonds. (Federal Reserve Bulletin, August 1966.) This does not take into account security loans extended by institutions other than Stock Exchange firms or banks. Moreover, the importance of the interest deduction generally is reflected in statistics released by the Treasury Department, showing that the deductions for interest claimed by all taxpayers on Federal income tax returns in 1963 amounted to $10,274,461,000, accounting for approximately 25% of all itemized

4. The status of the *Stanton* case is also in urgent need of clarification. The Second Circuit's opinion makes no reference to *Stanton*.[17] This, plus the equivocal character of the majority opinion in *Stanton* leaves the issue in a state of uncertainty. The implicit threat of the tax avoidance test advanced by the Second Circuit can only be expected to have a dampening effect on investing and trading in United States Treasury obligations—a matter of obvious importance to the Federal Government, as well as to investors generally and the securities business. This effect may be hard to measure, but investors and their advisers will be aware of the threat and may be expected to be wary of incurring an inevitable loss because of disallowance of the interest deduction. The uncertainty attending the issue is reflected in the fact that four separate opinions were written in the *Stanton* case. The impracticality of the principle adduced here and the burdens it imposes on the administration of the Revenue, with the attendant potential for discrimination, compound the need for clarification.

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deductions (Statistics of Income—1963; U. S. Treasury Department [publication No. 79 (1-66)]).

This Court has frequently granted certiorari on the basis that the cases represented important federal tax questions. Such cases include: *Crane* v. *Commissioner*, 1947, 331 U. S. 1, involving basis of property; *Libson Shops, Inc.* v. *Koehler*, 1957, 353 U. S. 382, involving the carryover of net operating losses; *P. G. Lake, Inc.* v. *Commissioner*, 1958, 356 U. S. 260, involving assignment of oil royalty payments; *Camnarano* v. *Commissioner*, 1959, 358 U. S. 498, involving deductions for amounts paid to influence legislation; *Rudolph* v. *U. S.*, 1962, 370 U. S. 269, involving definition of income and ordinary and necessary business expenses; *Meyer* v. *U. S.*, 1964, 375 U. S. 233, involving tax liens; *Lykes* v. *U. S.*, 1952, 343 U. S. 118, involving deductibility of legal expenses.

[17] The Commissioner filed an appeal in the *Stanton* case, but this was later withdrawn.

The Facts

(Max Barnett, et al. v. Commissioner)

Max Barnett (hereinafter Petitioner) in 1957 was the recipient of a $50,000 prize pursuant to a contest conducted by a New York newspaper. Petitioner filed a joint Federal income tax return with his wife for the year 1957, employing the cash receipts and disbursements method of accounting.

On or about December 20, 1957 petitioner purchased from the Gibraltar Financial Corporation (hereinafter GFC) $750,000 face amount of U. S. Treasury Certificates of Indebtedness, 3¾% due December 1, 1958 (hereinafter Treasury Certificates) at a price of 100.23 plus accrued interest for a total of $757,090.49. GFC was a dealer in Municipal, State and Federal bonds. Petitioner paid GFC $9,199.86 by check, as margin on the purchase of the Treasury Certificates.

Petitioner executed a note for $747,890.63 payable to GFC, dated December 23, 1957, for the balance of the purchase price, bearing interest at the rate of 5¾% per annum and due September 23, 1958. The note provided, among other things, that petitioner could prepay the principal of the loan at any time without penalty except that if prepaid within thirty days from the date of the note he would be liable for thirty days interest; and if the interest due on the note was prepaid, the interest rate would be reduced to 5½% or 5⅝% depending on when prepaid. On December 26, 1957 petitioner paid GFC $30,850.49 by check as interest in advance to the maturity of the note.

On December 20, 1957, GFC purchased $750,000 face amount of Treasury Certificates from The First Boston

Corporation, a well known dealer in government bonds. On December 23, 1957, GFC borrowed $740,000 at 4% interest from Cleveland Trust Company which it used to finance the $747,890.63 loan to petitioner.

Petitioner pledged the Treasury Certificates, which he had purchased, with GFC to collateralize his loan for $747,890.63 giving to GFC, among other things, the right to hypothecate and re-hypothecate those securities. GFC re-hypothecated the Treasury Certificates with Cleveland Trust to collateralize its $740,000 loan.

GFC did not sell these or equivalent Treasury Certificates "short". Chemical Bank, as the correspondent of Cleveland Trust, at all times during the term that the loan to GFC was in force, held the Treasury Certificates delivered by GFC (which were pledged by petitioner) in identical form as security for GFC's loan with Cleveland Trust. There were no arrangements between petitioner, GFC or anyone else concerning the continued ownership or disposition of the Treasury Certificates; and the ultimate disposition thereof was solely within the control of petitioner. All transactions were affected at the prevailing market prices for the days involved.

On January 2, 1958 petitioner sold to GFC $250,000 face value of the Treasury Certificates at a price of 100.25 plus accrued interest for a total of $252,803.06. The proceeds from such sale were used in part to reduce petitioner's loan with GFC, and the balance refunded to him. On January 3, 1958, GFC mailed its check to petitioner in the amount of $3,506.18 which represented his profit on the purchase and sale plus one third of the margin deposit originally put up by him.

On January 17, 1958, petitioner sold to GFC the remaining $500,000 face value Treasury Certificates at a price of 101 plus accrued interest for a total of $507,575.55. The proceeds from such sale were used in part to reduce petitioner's loan with GFC, and the balance refunded to him. On January 20, 1958 GFC mailed its check to petitioner in the amount of $8,981.80 which represented his profit on the purchase and sale plus the balance of the margin deposit originally put up by him.

Following the sales by petitioner and the repayment of his loan from GFC, petitioner received refunds of interest representing the unearned portion originally prepaid on December 26, 1957, as follows:

January 3, 1958	$ 9,140.89
January 20, 1958	18,282.17
	$27,423.06

Petitioner deducted in his 1957 joint Federal income tax return, interest in the amount of $30,850.49 representing the amount paid as interest to GFC on December 26, 1957. All rebates of interest and gain on the sale of the securities were reported in their 1958 joint Federal income tax return.

The Facts

(Michael J. Ippolito, et al. v. Commissioner)

Michael J. Ippolito (hereinafter petitioner) was found to be the holder of a winning ticket on the Irish Sweepstakes and, in 1955, collected $138,567.50. Petitioner filed a joint Federal income tax return with his wife for the year 1957, employing the cash receipts and disbursements method of accounting.

On or about December 23, 1955, petitioner, through his accountant, purchased from the Gibraltar Financial Corporation (hereinafter GFC) $1,000,000 face amount of U. S. Treasury Certificates of Indebtedness, 2⅝ percent due December 1, 1956 (hereinafter Treasury Certificates) at a price of 100.1 plus accrued interest for a total of $1,001,864.75. GFC was a dealer in Municipal, State and Federal bonds.

Petitioner executed a note, with recourse, dated December 27, 1955, for $1,000,000 payable to GFC for part of the purchase price, bearing interest at the rate of 4 percent per annum and due December 1, 1956. The note provided, among other things, that petitioner could prepay the principal sum of the loan at any time without penalty except that if prepayment occurred within 30 days from the date of the note, he would be liable for 30 days' interest.

Petitioner paid GFC $1,864.75 by check as margin on the purchase of the Treasury Certificates, and pledged the Treasury Certificates to collateralize his loan, giving to GFC the right to hypothecate and rehypothecate the securities. On or before December 27, 1955, petitioner paid GFC $37,777.77 by check as interest in advance on the note for

$1,000,000 to the maturity of the note; and on the same date paid GFC $2,500 by check as a loan placement fee.

On or about December 23, 1955, GFC purchased $1,000,000 face amount of Treasury Certificates from C. J. Devine & Co., a well-known dealer in Government bonds. On or about December 27, 1955, GFC borrowed from Cleveland Trust Company a total of $1,945,000 on a 3½ percent interest demand note pledging as collateral security therefor $2,000,000 face amount of Treasury Certificates. As part of such borrowing, GFC rehypothecated the $1,000,000 face amount of the Treasury Certificates previously pledged with it by petitioner to secure $965,000 of the aforesaid total loan of $1,945,000 [the portion of the loan obtained for petitioner's account].

On or about January 12, 1956, petitioner sold to GFC the $1,000,000 face amount of Treasury Certificates at a price of 100-3/64 for a total price of $1,000,468.75 plus accrued interest of $3,084.02.

On or about January 17, 1956, GFC mailed to petitioner its check in the amount of $3,240.27, representing the balance in petitioner's account after the sale of the securities.

On the same day GFC mailed its check in the amount of $34,444.47 to petitioner as a rebate of interest previously prepaid in accordance with the terms of the note.

Petitioner deducted, in his 1955 joint Federal income tax return, interest in the amount of $37,777.77, representing the amount paid as interest to GFC on December 27, 1955, together with the $2,500 loan placement fee. All rebates of interest and gains on the sales of the securities were reported in their 1956 joint income tax return.

GFC did not at any time sell short the same or equivalent securities as the Treasury certificates purchased by petitioner which are here in issue. Cleveland Trust Company, at all times here material held $1,000,000 of these Treasury certificates as collateral for its loan to GFC.

All transactions of the petitioner here at issue were effected at the market prices prevailing for the day of execution. Neither petitioner nor his accountant had any arrangements with GFC concerning the continued ownership or disposition of the treasury certificates (other than the usual protective provisions set forth in petitioner's note), and the ultimate disposition thereof was solely within the control of petitioner.

Ippolito and Barnett—The Issue of "Sham"

The fact differences between the cases of *Ippolito* and *Barnett* and that of *Goldstein* are: (1) the latter held the original Treasury Notes, which she had purchased, for approximately 12 months in one instance and 18 months in the second instance; Ippolito held his securities 25 days and Barnett for 12 to 30 days. (2) Goldstein obtained her loans directly from the banks concerned. Ippolito and Barnett obtained their loans from the broker who had purchased the securities; the broker rehypothecated the securities with the Cleveland Trust Company which retained them throughout the duration of the transactions at issue.

There was no short sale by anyone of the securities purchased by either Barnett or Ippolito, or of equivalent securities.

In *Barnett*, the Tax Court noted that the certificates were purchased in the name of the broker, GFC, and that

neither the broker nor Barnett had possession—the certificates were held by Chemical Corn Exchange Bank in New York, as correspondent for the lender bank, Cleveland Trust Co. The Court found that: "Petitioner did not have any control at any time over the $750,000.00 of certificates;" also, that petitioner failed to prove that the arrangements with GFC amounted to anything more than a "paper transaction" (App., Barnett, 22a-24a).

The Tax Court found, further, that the arrangements had no substance and bona fides apart from income tax purposes.

The Court of Appeals agreed with the last conclusion and said, "it follows from what we said in *Goldstein* that the Tax Court's disallowance of the deduction must be affirmed" (App., Barnett, 42a).

In *Ippolito*, where Judge Fay of the Tax Court had not made such a finding, the Court of Appeals nevertheless concluded that, "the facts the Tax Court did find fully warrant the same conclusion" (App., Ippolito, 14a).

It is thus clear that the Court of Appeals has applied the same principle in these cases as in *Goldstein*.

The Court of Appeals further concluded in the *Barnett* case that the nature of the arrangement between the taxpayer and his broker, plus the extremely short duration of the loan transaction, lead to the conclusion that "the purported loan transaction here was indeed without substance and was a 'sham' of the discredited *Goodstein* variety . . ."[18] (App., Barnett, 43a).

Petitioners submit that this conclusion is wholly without factual basis. The *Goodstein* case was one of those in

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[18] *Goodstein* v. *Com., supra,* referred to by the Court, should not be confused with the *Goldstein* case now before this Court.

which the pledgee-lender sold short the same securities as were pledged with it, borrowed the pledged securities to make delivery against its sale and advanced the proceeds to the pledgor; this advance was the loan at issue in *Goodstein* and like cases. The Courts took the position that the sale by the pledgee-lender could properly be attributed to the taxpayer-pledgor and the short sale by the pledgee thus nullified the investment by the taxpayer and there was no real indebtedness based on an hypothecated investment. See *MacRae* v. *Com., supra* at page 27.

The *fact* simply is that *there was no short sale by anyone* in the *Barnett* or *Ippolito* cases, any more than in *Goldstein*. Examination of the facts in either of these cases will show that the dealings between the taxpayers and the broker were no different from those in any other of the thousands of margin transactions that take place every single business day.

It is evident that the lower Courts have labelled the transactions in *Barnett* and *Ippolito* as "sham" not because of a lack of substance or reality in the purchase of the Treasury Certificates or of their hypothecation, but because of the tax avoidance motive of the transaction. This is made clear by this further statement in the Court of Appeals' opinion in *Barnett*:

> "This plan is similar to, but significantly more transparent than the plan devised by the taxpayer and her advisors in *Goldstein* v. *Commissioner*, —— F. 2d —— (2 Cir. 1966), also decided today."

Since the Court held that the transactions in *Goldstein* were real, not sham, it is clear that when it referred to the instant transactions as "more transparent" than *Gold-*

stein, it meant only that the tax saving purpose was more obvious—more readily visible to the naked eye. Petitioners agree that this is so; but it does not disqualify their transactions for the Section 163 deduction. As stated by the First Circuit Court in *Fabreeka Products, supra,* in a similar context:

> "But this describes neither a sham transaction, nor one unmarked by events or risks beyond the control of the taxpayer nor one different in substance and effect from what it appeared to be on its face. Cf. *Commissioner* v. *Tower,* 1945, 327 U. S. 280; *Johnson* v. *Commissioner,* 2nd Cir. 1936, 86 F. 2d 710; *Gregory* v. *Helvering,* 1935, 293 U. S. 465; *Knetsch* v. *United States,* 1960, 364 U. S. 361."

These petitioners kept their securities for less than a month. But there is no requirement in Section 163 as to the time that hypothecated securities must be held to qualify. Many margin securities transactions last no more than a day, yet the interest paid is allowable as a deduction, and it is regularly allowed. Facts cited by the Courts as indicative of "sham", such as that petitioners did not have possession of their securities (App., Barnett, 28a, Ippolito, 14a), merely describe the normal margin transaction.

These petitioners purchased their securities validly and obtained legal, enforceable bank loans through their broker to pay portions of the purchase price. They paid the interest in cash.

The lower Courts have manifestly equated tax avoidance motive with "sham" in these cases, contrary to law. Cf. *Fabreeka Products, Inc.* v. *Com., supra.*

The real issue in these cases is the same as in *Goldstein*: Whether petitioners' tax saving motive disqualifies the interest which they paid on their indebtedness as a deduction under Section 163. Certiorari should be granted in all three cases to determine that question in view of its importance and the conflict with the *Fabreeka* and *Maysteel* cases, *supra*, as well as the other grounds here advanced.

CONCLUSION

For the reasons set forth, it is respectfully urged that a writ of certiorari issue to the Court of Appeals for the Second Circuit in each of the cases herein joined.

Respectfully submitted,

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